

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
LAWRENCE R. GREEN)

Appearances:

For Appellant: John M. Cranston, Attorney at Law

For Respondent: W. M. Walsh, Assistant Franchise Tax
Commissioner; Milton A. Kuot,
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 18593 of the Revenue and Taxation Code (formerly Section 19 of the Personal Income Tax Act) from the action of the Franchise Tax Commissioner on the protest of Lawrence R. Green to a proposed assessment of additional personal income tax in the amount of \$153.53 for the year 1939.

The additional assessment arose from the Commissioner's disallowance of the following deductions from gross income: (1) interest paid by Appellant, \$4,143.01; (2) legal and accounting fees and sundry expenses in connection with tax matters, \$1,655.10; (3) Babson Financial Service Reports, \$180.00; and (4) rent on a safety deposit box, \$10.00.

The question involved in item (1) is whether a transferee of assets of an estate may deduct for income tax purposes the interest paid by him on an estate tax deficiency assessed after the distribution of the assets.

Appellant and his brother on October 13, 1931, received final distribution of their father's estate in equal shares as residuary beneficiaries. Subsequently, a Federal estate tax deficiency was levied against the estate, a settlement of which was effected in 1939 when the Government received \$17,244.81, together with interest at 6 percent per annum from July 5, 1931, to July 8, 1939, in the amount of \$8,286.01, Appellant and his brother each paying one-half of the deficiency and interest. Of Appellant's payment of interest, \$140.32 accrued prior to final distribution of the estate (from July 5, 1931, to October 13, 1931) and \$4,002.69 accrued after final distribution (from October 14, 1931, to July 8, 1939). In his income return for 1939; Appellant deducted as interest all the interest, i.e., \$4,143.01, thus paid by him..

Section 8(b) of the Personal Income Tax Act (now Section 17304 of the Revenue and Taxation Code) provides

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"In computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness of the taxpayer...."

It is well established that interest is not deductible from gross income under the similar provision of Section 23(b) of the Federal Internal Revenue Code unless it is paid upon a debt owed by the payor. Scripps v. Commissioner, 96 Fed. 2d 492, certiorari denied, 305 U.S. 625.

Federal cases determining whether interest paid by a transferee on a transferor's tax deficiency is deductible by the transferee have involved a construction of Section 900(a) and Section 311(a) of the Internal Revenue Code. These sections are substantially identical, the only difference being that Section 311(a) covers transferee income tax liability while Section 900(a) relates to transferee liability with respect to estate taxes, and the same tests are applied under both. United States v. First Huntington Nat. Bank, 34 Fed. Supp. 578, affirmed 117 Fed. 2d 376; Edna F. Hays et al., Executors, 34 B.T.A. 808. Section 900(a) provides as follows:

"Sec. 900. Transferred assets.

(a) Method of collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this subchapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) Transferees. The liability, at law or in equity, of a transferee of property of a decedent, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed by this subchapter."

It has been held that a transferee is not entitled to deduct interest either on an estate tax deficiency determined against him under Section 900(a) or on an income tax deficiency under Section 311(a). Koch v. United States, 138 Fed. 2d 850; Nunan v. Green, 146 Fed. 2d 352, reversing 3 T.C. 74; Commissioner v. Green, 148 Fed. 2d 157; Commissioner v. Henderson's Estate, 147 Fed. 2d 619. Commissioner v. Green, as a matter of fact, involved a claim by Appellant herein of a deduction for Federal income tax purposes of the very interest her: in question. All these decisions took the view that Sections 311(a) and 900(a) did not create a substantive right, but merely provided the Government with a new remedy for enforcing the existing liability at law or in equity of transferees of property. The indebtedness, the courts state-, remained the obligation of the transferor and was

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discharged with funds that belonged to him but which were held in trust either for him or his creditors by the transferee. Therefore, the payment of the interest was not regarded as the payment by the transferee of a debt due from him, and it was held that he was not entitled to a deduction.

Subsequent to the above decisions, in a line of cases beginning with Commissioner v. Breyer, involving interest on Federal estate tax deficiencies, and Commissioner v. Koppers Company, involving interest on Federal income tax deficiencies, both reported at 151 Fed. 2d 267, the Federal courts held that the interest on the deficiencies for the period after the transferees received the assets was paid on the indebtedness of the transferee and was, therefore, deductible by the transferees for Federal income tax purposes. Amelia E. Collins, T.C. Memo. Op., Dkt. 109843 (March 13, 1944) dismissed 153 Fed. 2d 1022; Robert L. Smith, 6 T.C. 255; Philip D. Armour, 6 T.C. 359; Edith K. Timken, 6 T.C. 483; W. D. Haden Co., T.C. Memo. Op. Dkt. 5789 (April 9, 1946), affirmed 165 Fed. 2d 588. Interest Accrued prior to distribution, however, was held not deductible by the transferee as it did not relate to his indebtedness. Commissioner v. Breyer, 151 Fed. 2d 267.

The Court in the Breyer and Koppers cases rejected the trust fund doctrine followed in the earlier decisions and took the view that if interest on a deficiency is to be assessed against and collected from a transferee in the same manner and subject to the same provisions and limitations as in the case of interest on a deficiency imposed against a transferor, then the interest against the transferee is to be collected subject to the allowance of a deduction therefor in favor of the transferee in the same manner and to the same extent as in the case of the transferor. The court also noted that the legislative history of the pertinent law indicated that it was the intention of Congress that the liability of a transferee resultant upon a transfer of assets was an indebtedness on his part to the Government. The court rejected the view that because liability for payment of a deficiency and interest on the part of the transferee was secondary, it should not be considered that any such payment which he makes is not made on his own indebtedness.

The Commissioner of Internal Revenue acquiesced in the Breyer and Koppers cases (CB 1946-1, p.3), and the Ninth Circuit Court of Appeals in Commissioner v. Collins, 153 Fed. 2d 1022, dismissed an appeal from the Tax Court in Amelia E. Collins, supra. After the dismissal of the Collins case, the Supreme Court dismissed, as moot, the question involved in that case, which had been certified to it by the Ninth Circuit, Commissioner v. Collins, 327 U.S. 764.

In view of the now prevailing authorities, the interest in the amount of \$4,002.69 on the estate tax deficiency of Appellant's father for the period after the property was received by Appellant is to be regarded as interest on Appellant's own indebtedness and, therefore, was deductible by him under Section 8(b) of the

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Personal Income Tax Act. On the other hand, the interest in the amount of \$140.32 which accrued prior to the distribution of the estate was not deductible.

The deduction as a business expense of the amount of the legal and accounting fees, the cost of the Babson Financial Service Reports and the rent of the safety deposit box under Section 8(a)(2) of the Act is precluded by Meanley v. McColgan, 49 Cal. App. 2d 203, and Higgins v. Commissioner, 312 U.S. 212. Although that Section was amended in 1943 to permit the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income", the amendment, unlike the comparable amendment of Section 23(a)(2) of the Federal Internal Revenue Code, is not retroactive. As the State amendment is applicable to taxable years beginning after December 31, 1942 (Stats. 1943, Chapter 353, Sec. 129), it does not govern the present appeal which involves liability for the year 1939.

O R D E R

Pursuant to the views of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 18595 of the Revenue and Taxation Code, that the action of Chas. J. McColgan, Franchise Tax Commissioner, on the protest of Lawrence R. Green to a proposed assessment of additional personal income tax in the amount of \$153.53 for the year 1939, be and the same is hereby modified; the action of the Commissioner in disallowing the deduction from gross income of interest is hereby reversed as to the amount of \$4,002.69; in all other respects the action of the Commissioner is hereby sustained.

Done at Sacramento, California, this 15th day of September, 1949, by the State Board of Equalization.

Geo. R. Reilly, Chairman
J. H. Quinn, Member
J. L. Seawell, Member
Wm. G. Bonelli, Member

ATTEST: Dixwell L. Pierce, Secretary